



Business & Social Science
IJRBS

Research in Business & Social Science

IJRBS VOL 9 NO 3 ISSN: 2147-4478

Available online at www.ssbfn.net
Journal homepage: <https://www.ssbfn.net/ojs/index.php/ijrbs>

Emerging policies and the effectiveness of corporate governance mechanisms on earning quality: A conceptual framework for Gulf cooperation council



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ARTICLE INFO

Article history:

Received 08 April 20

Received in revised form 23 April 20

Accepted 27 April 20

Keywords:

Earnings Quality, GCC Countries,
Corporate Governance, Conceptual
model

JEL Classification:

M42; G34; M48

ABSTRACT

Current study review extant empirical researches on the relationship between CG and EQ. However, the scope of the reviewed studies was shown to vary, most studies on CG and EQ are specific in focus, with different studies focusing on specific aspects or measures of CG. This study evaluates the role of emerging policies and the effectiveness of corporate governance mechanisms on earning quality within a conceptual framework for the Gulf cooperation council. This study concludes that the majority of companies with big board size, higher board independence, and more frequent meetings have improved EQ. Also, the result indicates companies with big audit committee size, a larger number of independent directors, more audit committee meetings and more experts tend to have an increase in EQ. Finally, this review emerged as a framework suitable for assessing the level of EQ disclosed and the relationship between CG and EQ base on GCC policies.

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Introduction

An emerging issue among the Gulf Cooperation Council (GCC) is the effort towards enhancing its policies or regulatory strength for effective corporate governance (CG). These policies are developed as means to minimize misconduct, bribery and corruption while ensuring transparency and disclosure by corporate bodies. The disclosures by corporate bodies is related to earnings quality (EQ), in turn, EQ guides capital market participants in making decisions regarding investments thus, directly influences firm's cost of capital. To verify the association between various CG practices and EQ, several empirical researches emanated. However, there are issues among the findings of extant researches, as the concepts has proved indefinable and often argumentative because extant researches that examined EQ and CG indicated weak and inconsistent results.

In the wake of the recent regulatory policies among GCC, the current study through extensive assessment of extant Literature attempt to establish trends and correlation between various CG practices and EQ. Base on the review a relevant framework consistent with the regulatory policies and CG practices among the GCC is developed.

Studies on theory as well as empirical literature indicate the dependency between CG and reported earnings. However, this relationship is not fully understood specifically in the perspective of GCC countries. Predominant of the existing studies are concentrated within United State of America (USA) while research limitations exist among other regions such as the GCC. Additionally, there exists currently no consensus evidence regarding CG and EQ, that is, either they

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are complementary or substitute mechanisms (Gaio & Raposo, 2014). Corporate governance is an oversight activity done by the BOD and the AC to maintain a process of quality financial reporting. The limitations imposed by poor accounting information could lead to costly information procurement and monitoring instruments. Undeniably, investors will usually demand greater governance arrangements in the case where firms' earnings are not clear or lack adequate information.

Firms preferred to employs higher performance metrics in cases that accounting information is of limited use (Bushman et al., 1996). Ugbede et al. (2013) resolved that in Nigerian banks, the poor CG structures and practices greatly led to higher incidence and broader scope of earnings manipulation. Though, in Malaysian banks, the strong CG structures and practices were the central factors that predict and curtail the degree and level of earnings management. While, several studies examining the influence of CG practices on EQ in other contexts exist, there is however limited research that investigates this issue within the GCC context. A special characteristic of the GCC countries is the existence of the highest private and individual ownership while the minor shareholders have feeble legal protection. In light of the scanty research in this domain amongst the GCC, this study reviews studies on corporate governance mechanisms, which might relate to the earning quality for GCC countries. Accordingly, this review aims at developing a framework that could be employed towards establishing the level of CG measures by the GCC companies and their interrelation with EQ. This study was achieved through searches across various data bases, using the key words in the study. Followed by comparison of findings and extraction of relevant information to help achieve the goal of the study.

The study focuses on the evolvement of a framework that focus on financial alongside non-financial firms listed in majorly GCC countries such as: Bahrain, Oman, Kuwait, Qatar, KSA, and UAE). Based on the review, a new framework emerged that conceptualizes the interlinkages between CG and EQ in the GCC Countries. This framework considers three mechanisms of CG which are: BODs, AC and audit quality. Whereas, a total of 11 factors are postulated as measures of the level of CG in GCC. The conceptual framework is subsequently presented in Figure 1.

The remainder of this study is organized as follows. The next section provides a review of the extant literature, the conceptual framework of the study and conclusions.

Literature Review

Corporate governance (CG) signifies the structure and functioning of the corporate polity. However, it was after the manifestation of two major events in the nineteenth century that CG started gaining much attention. The first event was in Russia, Asia and Brazil, where during the financial crises in 1998, the world economic and geopolitical setup were endangered due to deficient corporate behavior and governance. The second took place after the 2001 several self-inflicted scandals among which include some companies like; Enron, Banco Espirito Santo and Satyam Computers. These events smeared previously defective corporate fabrics and further destabilized world financial system (Pillai & Al-Malkawi, 2018). In recent times, the turbulent instabilities in oil market globally, Middle East political turmoil and the uncertainties of Brexit as well as US presidential policies led to economic diversification across Gulf Cooperation Council (GCC) as survival mechanism rather than success mantra. Nevertheless, the enlisted issue are pointers to innumerable ultimate reasons affirming why CG is now a key challenge to sustainable global development (Becht et al., 2002; Pillai & Al-Malkawi, 2018).

The GCC are part of the developing capital market and have given much attention to improving its regulations through the development of CG regulations (Al-Sartawi, 2015), promotion of voluntary disclosure then investing in the growth of human resources as well as information systems. The GCC stand as or is regarded as "the heart of the Middle East" owing to its geographical location which enables the provision of rapid and effective access to entire market within the region. Essentially, the GCC concentrates on enticing domestic alongside foreign investors by employing numerous incentive measures. Such incentives includes not having either personal nor corporate income tax and complete foreign ownership of the real estate in virtually every sectors as well as business assets. Also, GCC play the role of financial center that is currently envisioned as foreign investors destination (Al-Sartawi et al., 2016; Amrah & Obaid, 2019). Furthermore, for these investors to invest in the GCCs, some preferred qualities includes; good CG practices, appropriate EQ, alongside qualified and talented people, together with well-developed information systems.

Although CG systems differ between countries, it has however been agreed that certain mechanisms such as ensuring corporate disclosure and transparency must exist to curtail the menace resulting from bribery, misconduct and corruption (Wahyudin & Solikhah, 2017). Thus, CG has been mounted to achieve a system of supervision that utilizes practices such as board structure, reporting, duality, along with remuneration for equipping shareholders with needed information to be able to ascertain management accountability for decisions made (Al-Malkawi & Pillai, 2012). Also, CG has been recognized as one of the factors that can reduce agency costs; therefore, by filtering through limiting unscrupulous conducts by management, the quality and reliability of reporting can be improved and also the value of the company will increase. One of the most important tasks of CG is to guarantee good financial reports which is related to earnings quality (EQ).

There exist no general definition for earnings quality although, the concept is concerned with the adequacy of information on earnings to indicate the economic reality (Antonio, Laela, & Darmawan, 2019). Healy and Wahlen (1999) asserted that the worth of any financial statements decline whenever reported earnings are not in consonance with economic reality. Several measures for EQ have emerged from extant researches such as accrual quality (Richardson et al. 2005). Similarly, high earnings quality (EQ) is more desirable and sustainable because a high EQ can stipulate information concerning future firm's earnings (Antonio, Laela, & Darmawan, 2019; Penman & Zhang, 2002). Finding by earlier studies indicated a positive market response to earnings quality, particularly for inexperienced investors, as experienced or competent investors indicated a negative relationship between EQ and market response (Kalelkar & Nwaeza, 2011; Dechow, Ge & Schrand, 2010). Thus, capital market stakeholders normally decide on investments by relying on earnings reported. EQ is therefore directly associated with firms cost of capital and a critical factor in terms of corporate sustainability. From this sustainability standpoint, previous findings have shown that response of the market participants to EQ differs to certain extent (Park, 2018; Lee et al., 2018).

The relation between CG and EQ is indefinable and often argumentative among accounting researchers because some empirical studies that examine EQ and CG have found weak and inconsistent results (Larcker et al., 2007). There are two types of studies relative to relationship between CG and a firm's EQ. One category postulates that CG is among the key determinants of EQ whilst, the other category postulates that investors anticipate CG when earnings are reflected in the stock price (Shin & Kim, 2019). Accounting information is key in the CG process (Bushman & Smith 2001, 2003), whereas, financial reporting alongside disclosure are taken as significant components of CG (La Porta et al., 1998). The structures and practices of CG have been shown by different kinds of literature to consider important the efficiency of reported earnings, especially in the reduction of management opportunistic behavior towards earnings (Dechow et al., 1996). Financial accounting could concurrently represent an input or output of CG, as such higher EQ can lead to more operative governance mechanism or vice versa. Based on this, there is a need for complementarity between CG and EQ.

The study focuses on the evolution of a framework that focus on financial alongside non-financial firms listed in majorly GCC countries such as: Bahrain, Oman, Kuwait, Qatar, KSA, and UAE). Based on the review, a new framework emerged that conceptualizes the interlinkages between CG and EQ in the GCC Countries. This framework considers three mechanisms of CG which are: BODs, AC and audit quality. Whereas, a total of 11 factors are postulated as measures of the level of CG in GCC. The conceptual framework is subsequently presented in Figure 1.

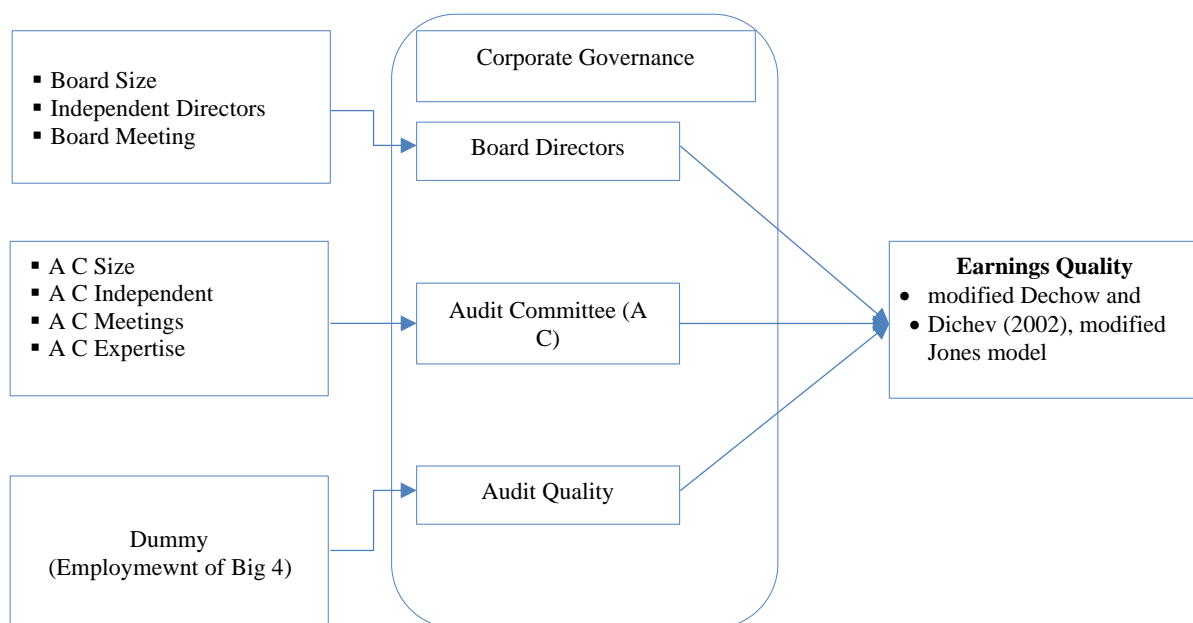


Fig. 1: The Conceptual framework of the study

Corporate governance mechanism and measures

Corporate governance is an important global process considered to influence EQ, despite this, to date, the concept is deficient of strong putative theoretical backing or pattern (Abdullah & Valentine, 2009; Larcker et al., 2004). Different research has underlined quite a lot of variables considered as internal mechanisms among which include: BOD, AC and Audit quality. An analysis of the pattern of the nexus between CG and EQ has been the focus of most conducted studies. These studies employ different methodological approaches and CG mechanisms depending on data availability and the region under study. Among the key CG mechanisms in extant literature are board structure, reporting, duality, and remuneration. This study consequently reviews the various Measures of CG mechanisms.

Corporate governance mechanisms measurement

Three important measures of CG mechanisms are focused in this review, these are; board of directors (BOD), audit committee (AC) and audit quality (AQ). In the case of BOD, three board characteristics are considered, which are; board size “number of directors serving the board”; independent directors “percentage of independent directors serving the board” and BOD meetings (number of board meetings during the year). For audit committee, four characteristics were considered; the AC size (number of directors); AC independent (percentage of independent directors); AC meetings (total of AC meetings per year) and AC expertise (percentage of audit committee members with financial expertise). While audit quality has been considered as dummy variables. Findings of literature concerning these measures of corporate governance are further presented.

Earning quality measures

It has been asserted that EQ is mostly observed indirectly through the use of proxies, thus, several proxies exist in literature for measuring EQ (Francis et al., 2006; Dechow et al., 2010). According to Dechow et al. (2010), three broad categories of earnings quality (EQ) measures exist which are: statistical properties of earnings; the investor responsiveness to earnings; and lastly, external indicators of financial reporting quality. Numerous proxies have been employed in assessing earnings quality, in order to evaluate the various attributes of decision quality that researchers have measured. Several studies suggest that there is a single or best fit proxy for evaluating earnings quality in all decision contexts. Consequently, it indicates further that EQ is context-specific, and thus our assessment of the ability of each measure to capture decision usefulness is also context specific (Dechow, Ge & Schrand, 2010).

Among the notable measures are: Earnings response coefficients, Properties of earnings and External indicators of financial reporting quality measured as: Accounting and Auditing Enforcement Releases (AAERs), Benchmarking, restatements, and internal control procedure deficiencies reported under SOX) (Efendi, Srivastava, and Swanson, 2007; Karpoff, Lee, and Martin, 2008). Persistence and accruals, Asymmetric timeliness and timely loss recognition. This review employs two measurements of earning quality. First measurement is based on modified Dechow and Dichev (2002) accrual quality model by Francis et al. (2005). The second measurement of earning quality is based on modified Jones model adjusted for firm performance (Kothari et al., 2005).

Board of directors and earnings quality

Extant studies on BOD have indicated that numbers or size of directors is a factor critically relevant towards board effectiveness (Bedard et al., 2004). However, there is no agreement on how the board size affects effectiveness (Jamaludina, Sanusib & Kamaluddin, 2015; Peasnell et al., 2005). A larger board may provide more skills and proficient environmental relation (Kiel & Nicholson, 2003; Swastika, 2013). Within the context of criticisms of large boards, the agency theory offers explicit explanation regarding board features exclusive to the GCC. It asserts that, the numbers of independent directors and directors with similar responsibility on erstwhile boards tend to offer valuable advice hence, the establishment of a small board size with such expertise is ideal for GCC. Therefore, considering studies by Rahman and Ali (2006); Ahmed et al. (2006) and Vafeas (2000), this study also asserts the likely direction of the relation for the case of the GCC follows as; *“There is a negative relationship between EQ and the size of the board of directors”*.

Another important BOD measure is board independence (Black et al., 2006). The BOD monitors the top administration (Fama & Jensen, 1983). Nonetheless, studies have emphasized that becoming an effective monitor requires that a board should involve independent directors. These independent directors can act independently of managers as well as contribute ample wealth of experience to the corporation. Also, they show willingness towards developing a great deal of reputation within the labor market although, it depends on the monitoring performance (Fama & Jensen, 1983). Numerous studies such as Osma and Noguer (2007) have revealed a positive relationship among independent directors with the effectiveness of the board. Although most existing studies such as Peasnell et al. (2005) revealed that board independence has a negative link towards earnings quality behavior, which suggests that raising the number of independent board directors will lead to a decline in the frequency of earning quality. Conversely, findings in literature are mixed and inconclusive (Jamaludina, et al., 2015; Peasnell et al., 2005). Despite the mixed results, the theoretical argument, i.e. agency theory, undertakes that including more independent directors leads to increase the effectiveness of the board monitoring function. Hence, it concludes that *“the proportion of the independent directors on the board will have a significant effect on a firm’s EQ”*. Similarly, different kinds of literature have shown the number of meetings by BOD to have effect on EQ.

Audit committee and earnings quality

The size of audit committee (AC) means the number of serving directors in the AU whereas, this size can either be large, small or medium (Alkdai et al., 2012). Size is mainly influenced by company’s size and its BOD, however, larger size may not necessarily translate to a more effective functioning but may result to unnecessary debates which will delay decision making. In many instances, earnings quality misinform users of financial statements through provision of incorrect information on company’s financial performance or state (Iturriaga & Hoffmann, 2005). Therefore, a larger audit committee may be key to constraining the occurrence of earnings management (Al Matari et al., 2014; Rezaei & Abbasi 2015; Abdul Rahman & Heneem, 2006; Oradi et al., 2017). Contrarily, studies of Yang and Krishnan (2005); Hillman and Dalziel (2003) indicate existence of a negative and significant relationship between audit committee size with earnings quality. Following the ownership structure of GCC companies, it is expected that large audit committees should have a positive effect on financial reporting quality. The review therefore, postulates that the size of the audit committee can influence the effectiveness of EQ.

As suggested by Bedard et al. (2004), for AC to fulfill its goal, it should become independent. Several studies (Klein, 2006; Solomon, 2007; O'Sullivan & Wong, 1999) have reported a negative correlation between AC independence with earnings quality. A highly independent AC will give better governance than a less independent AC (Xie et al., 2003). The association that exist between percentage of independent directors in AC and earnings management has been reported to be negative and significant (Klein, 2002). Therefore, a logical assumption follows that: "the independence of an audit committee has a negative association with the earnings quality practice".

The number of audit meetings depicts a negative relation towards discretionary accruals. It was observed that increasing the frequency of meetings can decrease the earnings management among firms (Xie et al., 2003). However, it is worthy of note that, numbers of meeting does not suggest the amount of work that has been accomplished (Menon & Williams, 1994). Similarly, the audit committees with smaller number of meeting or without meetings are less likely to be good monitors. Concerning the expertise of the audit committee, Bedard et al. (2004) observed that firms whose AC members have high governance expertise reported lower earnings management. Based on the above kinds of narration, the review concludes to hypothesize as follows: "*The independence of the audit committee is associated with the EQ of a firm*. Similarly, the frequency of the audit committee meetings will have a significant effect on the EQ of a firm. While higher audit committee expertise will lead to higher EQ".

Audit quality and earnings quality

Audit quality can be improved by employing big 4 (external auditors) which also reduces agency costs based on the agency theory which consequently enhance the EQ. Two critical arguments ensues which are the reputation and deep pocket hypothesis. These explained the positive relationship existing amongst audit type and quality. According to reputation hypothesis, large auditors tend to deliver quality services because of their propensity to loose client-specific rents in the absence of quality services (DeAngelo, 1981). The deep pocket hypothesis that was proposed by Simunic (1980) and Becker et al. (1998) duel in the wealth of auditing companies that can be at stake in the event of litigation. Despite that the significance of big 4 has been reported to be inconsequential in many of the GCC countries (Aljifri and Mustafa, 2007; Alzharani et al., 2011), Al-Shetwi et al. (2011) highlight some big 4 roles in the minimization of earnings management among GCC. These variable results encourage the need for further studies. However, based on the significance attached to governance codes, concerted ownership structure along with outcomes from previous empirical assessments, as well as employment of the popular and significant big 4 in firms across GCC, this review further hypothesize the likelihood of a positive relationship between audit quality and EQ.

Conclusions

Current study review extant empirical researches on the relationship between CG and EQ. However, the scope of the reviewed studies was shown to vary, most studies on CG and EQ are specific in focus, with different studies focusing on specific aspects or measures of CG. The first category comprises of studies on board structure and EQ. The second category relates to studies on the audit committee and EQ. While the third category reviews studies on audit quality and EQ. In terms of their methods and tools of data analysis, some of these studies employed frequencies, percentages, line graphs or correlation coefficient to analyse the relationship between CG and EQ. Thus, these studies lack a sound econometric techniques for generalization of their findings or arguments. Another set of studies used just OLS in analysing their data. Also, the studies are considered limited to analysing variables that are quantitative and not variables in the qualitative form such as policy pronouncement. The final category employs more robust methods such as the logit/probit model, panels data models and the time series model such as difference and system GMM, or the ARDL models.

However, most of the reviewed studies have been shown to cover aspects or measures that include; board size, independent directors, and BOD meetings (Board structure), the audit committee size, audit committee independence, audit committee meetings and audit committee expertise as well as audit quality and policies. Whilst, we have very scanty studies focusing on the GCC countries. Consequently, the review presents the conceptual framework for further empirical assessment of the interrelationship between CG and EQ for the GCC countries. Finally the literature reviewed, indicated that not every CG measures have equal importance or influence on EQ. As revealed by the mixed findings, the relationship between CG and EQ differs base on socio-economic features, policies, cultural factors including average level of economic development of the region. The differences in the study area have accounted for the variations and inconsistencies in findings related to the CG and EQ relationship.

A recommendation is forwarded for an empirical study that examine the current framework to the GCC countries. The empirical result will show if companies with big audit committee size, more independent directors, more audit committee meetings and more experts are expected to have an increase in earning quality. Moreover, companies with higher audit quality are expected to have an increase in earning quality, this could be examined empirically across the GCC nations. Finally, a future empirical study will fill the gap that left by extant literature by assessing the level of earning quality practiced by listed companies in GCC. Especially, the relationship between CG and earning quality will be presented.

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